MICROFINANCIAL INSTITUTIONS AND FINANCIAL RESOURCES

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Abstract

The article has an analytical character. Most of the LDCs are highly indebted. According to statistical data, the debt initiative of the World Bank and International Monetary Fund is successful. Many analysts consider microfinance activity as one of the main beneficial factors. The analytical part of the article examines micro-financial activities and institutions from the aspect of acquisition of financial resources and their future development. The materials are drawn from the referenced sources. The conclusions from the analysis are pragmatically logical. Most similar analyses do not stem from the source conception, which this article addresses. It implies connection to other issues, which are necessary to deal with.

Key words: Less developed countries, microfinancing institutions, pawnbrokers, risks, poverty.

INTRODUCTION

Background

Poverty – field for microfinancing,

Poverty can be considered by using different measurements.

The **Human Development Index (HDI**) is the most common. The HDI – human development index – is a summary composite index that measures a country's average achievements in three basic aspects of human development: longevity, knowledge, and a decent standard of living. Longevity is measured by life expectancy at birth; knowledge is measured by a combination of the adult literacy rate and the combined primary, secondary, and tertiary gross enrolment ratio; and standard of living by GDP per capita (purchasing power parity PPP US$).

The human poverty index **(HPI-1 and HPI-2)** is also commonly used.

Poverty has traditionally been measured as a lack of income - but this is far too narrow a definition. Human poverty is a concept that captures the many dimensions of poverty that exist in both poor and rich countries-it is the denial of choices and opportunities for living a life one has reason to value.

The HPI-1 – human poverty index for developing countries – measures human deprivations in the same three aspects of human development as the HDI (longevity, knowledge and a decent standard of living).

The HPI-2 – human poverty index for selected high-income OECD countries – includes, in addition to the three dimensions in HPI-1, social exclusion.

For HPI-1 (developing countries): deprivations in longevity are measured by the probability at birth of not surviving to age 40; deprivations in knowledge are measured by the percentage of adults who are illiterate; deprivations in a decent standard of living are measured by two variables: the percentage of people not having sustainable access to an improved water source and the percentage of children below the age of five who are underweight.

For HPI-2 (selected high-income OECD countries): deprivations in longevity are measured by the probability at birth of not surviving to age 60; deprivations in knowledge are measured by the percentage of adults lacking functional literacy skills; deprivations in a decent standard of living are measured by the percentage of people living below the income poverty line, set at 50% of the adjusted median household disposable income; and social exclusion is measured by the rate of long-term (12 months or more) unemployment of the labour force (UNDP-HDR(2003)).

Other indexes are used. In respect of chronical malnutrition of some parts of the world, inhabitants (840 millions, especially of developing countries of Sub-Saharan Africa (SSA)). ones use indicator for monitoring developments in world food security is per caput food consumption, measured at the national level by the average dietary energy supply (DES) in calories or kilo-calories (cal, kcal) on the basis of national food balance sheets.

LDCs – Extreme poverty

Since the article deals with microfinancial activities and mainly microfinancial institutions (MFIs), the view on poverty is considered in the population segment with very low income. That is why MFIs work there.

Poverty is inability to attain a minimally adequate standard of Living. Using levels of private consumption as a measure of standard of living, the poor are identified by those living on a $1 a day and $2 a day. These international poverty lines specify the level below which private consumption is considering inadequate, and are measured, again in line with current practice, using purchasing power parity (PPP) exchange rates, which seek to correct for differences in the cost of living between countries

Almost half of the world population has an income $2 a day and less of which half daily financial income is about $1. In SSA the situation is worse than the world average. More than ¾ of the population has an income lower than $2 a day of which 65% under $1 (Binger, A. (2004)).

Binger's report has described the social dimension SSA has the highest share of the population below the minimum level of dietary energy, the, lowest net enrolment ratio in primary education, the lowest literacy rate, the, the highest infant and under-five mortality rates and the lowest proportion of immunized children. In SSA, three fourth of the poor, particularly the extremely and chronic poor, work and live in rural areas, and significantly more than half are expected to do so in 2025. Poverty is in general more severe in rural than in urban areas.

In SSA, small holders are the largest poor group. People in irrigated zones within rural areas face much lower poverty risk. The poorest of the rural poor live in remount areas. Remoteness, lack of natural, physical, human and social resources, but also social and political exclusion, explains persistent rural poverty. An attack on rural poverty in SSA will thus require action on many fronts.

Resulting from what is written, it is necessary to solve the problems in a holistic manner. All the issues (education, agriculture, environment, social security, health, etc.) have some common aspects. It is political atmosphere, social initiative, financial security and other considerations. Rightly, the financial resources provided - particularly through microfinancial activities, are the subject matter of the article.

The poor, who form the largest part of population in LDCs, usually operate in the non-monetized system are the informal financial system. The typical microfinance clients are low income persons that do not have access to formal financial institutions

Measuring should be taken to evolve a sound financial sector that enables enterprises to enter the market and operate effectively as well as help to restructure firms to operate effectively in competitive national, regional and global market (Binger A.)

The initiative of IMF and WBG for indebted countries (HIPC) is generally evaluated positively. Many economists are convinced that the change of political atmosphere towards liberalisation is the main cause. This change enabled microfinance activities to develop, especially MFIs, which are the main practical cause of current success. Indeed, if half humankind has daily incomes lower than $2 per capita, then the main target of economic activity must be right here. Each economic activity has its own weak points. First, here, it is the level of risk rate, corruption and greediness of those who try to abuse poverty. The rural environment of highly poor, indebted countries is delicate. Accordingly, MFIs are vulnerable.

Analysis

Currency risk in microfinances

The microfinancing industry is finding that rapid growth introduces new question and issues. One the biggest barely appeared on most screens just a few years ago. .Five years ago, loans made by international aid institutions and local commercial bank to namely formal microfinance institutions in local currencies, and were distributed to local borrowers in those same currencies.

During the past years the local currencies suffered from depreciation, and were also affected by the decrease in dollar rate against the Euro and Yen, so that the accepted credits could not be paid for. Because most commercial banks lend finance obtained from deposits of the private sector, especially from Equity investors, problems occurred. According to the deposit terms of contract the private sector wanted to give back capitalised deposits. Commercial banks had to use their own reserves and then got into trouble, so MFIs were not interested in lending either. The risk rate of was too high.

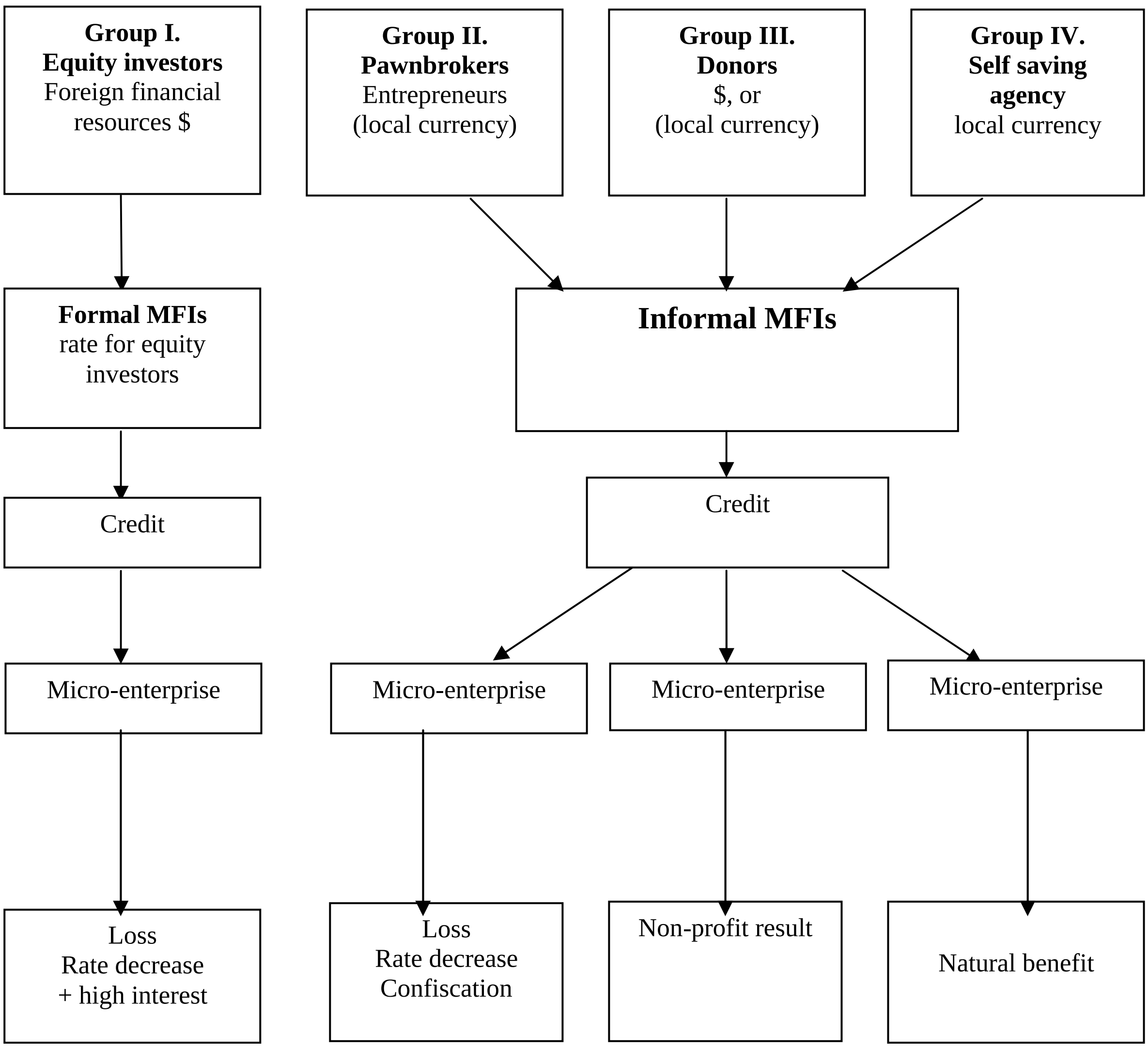
The risk is always a problem. Particularly in less-developed regions, where there is an absence of accounting transparency, the assurance does not work, there are no guarantees, there is an unstable political atmosphere, risk of natural disasters, etc. Nevertheless, access to risk has its own patterns. If the investor diverts from these risks they will still occur randomly.

To manage risk it requires:

- **A**: risk must be identified
- **B** loses must be numbered
- **C** risk must be economically accepted for commercials
- **D** risk utterance must be random

How to consider a situation of particular types of MFIs (according to their character and financial resources) and what do they not fulfill?

Trends in microfinance activity



Group I.

If formal MFIs are only active in some areas of rural environment, especially for microfinance activities of commercial banks, then these are the following trends: Financial resources are more or less unavailable for high interest rates for the poor population. The model Standard economics (SE) which seeks the optimum allocation of resources among alternative users. Standard economics does not ask how large the economy should be relative to the ecosystem, and does not accept needs of rural settings. Extremely poor self-employed people do not have access to financial resources and that leads to the impoverishment of other local residents. The availability of financial resources becomes operational with semi-market entrepreneurs.

If the formal microfinancial activities work only in the existing area of the countryside, it raises a risk of impoverishment for the local residents. This situation is dangerous, so there is no perspective.

Group I. + II.

It is the worst option. The indirect cooperation of formal MFIs of financial activities, commercial banks and leverage capital through pawnbrokers leads to centralisation of the whole pool of assets. Obviously, productivity and profitability of agricultural production are then increased. But unemployment and poverty are increased. For this process, conditions must be created, the transparent financial system of the state-wide (taxes, system of insurance, social network, system of revenue, etc.) must work.

For the highly indebted countries of the world, especially SSA countries, the conditions do not exist for the above-mentioned trend. Today, economic stability is uncontrollably threatened as well as the environment. It restrains the historical basis and tradition of existing countries. It is necessary to interconnect the traditional concepts with modern technology, and never to support one-sided development.

Group I. + III.

Many organisations and people recognise the need to help the extremely poor people in the world. They display their enthusiasm by a financial system of donation, and mainly by informal MFIs. Their enthusiasm and contribution to poverty eradication are unquestionable. However, most of them don't have the understanding for converting these organisations into formal financial organisations (Johnson, S.(1998)). This process is important, together with the expected economic development of highly indebted countries. In the long-run, there are no other ways.

The above-mentioned type of MFI is a contribution, primarily, to poverty eradication for hunger. It supports self-sufficiency for the population. However, the development leads to change towards formal MFIs.

Group I. + IV.

The model is based on voluntary tendencies to help. It is essential to support it. The best aid is, therefore, that which creates conditions, in which each one helps himself. In time these organisations can be created, along with more permanent structures like for example Village banking or Credit cooperatives (Huppi, M. (1990)). Another contribution is that, frequently there are the single organisations able to support small farmers, or craftsmen, in order to earn their living. Since there are always about 840 million of people undernourished, it is necessary to support these activities.

It is essential to support all activities so-called "downstream" and "upstream" otherwise, they do not operate well. It is assumed that larger organisations evolve in time, and will become firmly established in the remote areas.

Group II. - IV.

All of the services are self-services for members of MFIs (except category. II.). The members of MFIs are small privet non-market entrepreneurs (MSE). Most activities as MSEs are really very small: the majority of MSEs consist of only one person working alone. Self-employment is thus a central element in these economies. If one defines function MSE universe as those firms with 1 – 50 workers.

There are two categories of cooperatives in the MFIs:

1. Agricultural cooperatives; e.g. Small Farmer Group (SFG) or Small Farmer Group Associating (SFGA)
2. Financial cooperatives; e.g. Rotating Savings and Credit Association (ROSCA), Accumulating Savings and Credit Association (ASCRA)

It is necessary to understand these activities in relation to the overall economic development of the given country. They provide livelihood in remote areas, which lie beyond the interest of financial organisations. For the extremely poor in the rural population, their products are not available. If financial activities would not have worked, the percentage of starving would increase, would raise new waves of migration to the cities, and would relocate rural poverty into the city. The question arises, how the government of any given country can find the means to solve the new situation. However, informal MFIs cater for not only those beyond the financial system of the state, but also their activity is beyond its control.

It is an important transient situation, where formal MFIs must quickly penetrate and at a later stage some of the informal organisations must be transformed into formal.

Risk minimisation

The answer to the question how to minimise risk, is not simple. Each group of MFIs (from mentioned I. IV.) has a different conclusion. For formal MFIs there is in general a common recommendation for the microfinancing industry. I call attention to the risk originating from the provision of financial resources to MFIs. (It is not about the relationship MFIs – MSEs).

1. **Risk Avoidance**. It is not good to balance the cash flows with any US dollar surplus. There are two better ways, the diversification of foreign currencies and the utilisation of local currencies. Obviously, it is necessary to use all other financial instruments as well (system of insurance, system of guarantees, etc.)
2. **Off-Setting Risk**. Includes for example, long hedging, potential risk resulting from the devaluation of currency covered by trades in the capital market of the existing country, or by higher fees, etc.
3. **Risk Diversification**. In general, it is the diversification of allocation of resources. Allocate toughfully financial resources resulting from international funds from developed countries, within each individual country to different regions and localities.
4. **Consultant Services and Advisory**. It is not sensible just to supervise the distribution of financial resources. As soon as the finance is utilised, it doesn't have to be returned. Therefore a proactive special approach is necessary.
5. **Liberalisaton of political atmosphere**. Moderate the conditions for the risky environment by means of international action. It concerns the whole complex issues of developing countries.
6. **Historical Background**. Support traditional historical approaches and structures of countryside, implement properly modern technologies.

Group II.

1. **Leverage Avoidance**. It is not good to invest in MFIs, where pawnbrokers are active. Their purposes are clearly speculative with the aim of obtaining lands, livestock etc, to commercialise them, or establish big farms. It is true that larger farms improve the economic results in agriculture, but at the same time can increase unemployment and then poverty (it is caused by the current overall socio-economic situation in Sub-Saharan Africa). Simultaneously, they lead to serious loss for investors.
2. **Remove pawnbrokers.** Transfer MFIs into other type of funding, the best being into formal MFIs.

Groups III. and IV. are not considered from the view point of risk loss of the financial deposits. It is either donation or self-savings. In the first case, it is up to the donors to choose what purposes and goals to follow, but from the long-term viewpoint it is desirable to concentrate on formal MFIs. As a result, humanitarian goals are fulfilled, but at the same time help to accelerate the stabilisation and development of financial formal structures. In the second case, there is reciprocal control and guarantee for deposit. The heads of tribes, family clans, villages, etc. are recognised by the authority. This trust has developed over time.

Risk Mitigation

For a variety of reasons, most of the risk mitigation techniques employed by major corporations and investors worldwide are simply not available to microfinance institutions, or they are available at prohibitively high costs. If developed countries, and governments of developing countries, want economically to support the rural poor and proportionally to develop LDCs, then increased risk is unavoidable.

CONCLUSION

According to prevailing financial inputs, the distribution of MFIs gives a view of the philosophy of investors and their goals. As a result, an important insight of the financial situation becomes apparent in poor, and especially remote rural areas of LDCs. The understanding of the interdependence between the particular financial or business groups gives insights of financial losses and opportunities anticipated, or in some cases, reduced. It is another aspect of the microfinancial system. It mainly begins with the investigation of different groups, therefore the investigation of system nodes. The concept of this contribution is the analysis of relationships, relationships represented by cash flows, and the philosophy of the owners of these flows. In fact, this analysis opened the challenge and raised many questions relating to other developments of MFIs; confirming the need to transfer appropriate parts of informal MFIs into the formal Unit.

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